

Message Text

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ACTION EUR-12

INFO OCT-01 EA-07 NEA-10 IO-13 ISO-00 AID-05 CIAE-00
EB-07 FRB-03 INR-07 NSAE-00 USIA-06 XMB-02
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R 141530Z JUL 77
FM AMEMBASSY LONDON
TO SECSTATE WASHDC 6108
TREASURY DEPT WASHDC
INFO AMEMBASSY BONN
AMEMBASSY BRUSSELS
AMEMBASSY DUBLIN
AMEMBASSY NEW DELHI
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DEPARTMENT PASS FEDERAL RESERVE BOARD

TREASURY FOR DONALD E. SYVRUD, OASIA

E.O. 11652: N/A
TAGS: ECON. UK
SUBJECT: THE ECONOMIC SETTING AND THE POSSIBILITY OF A
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WAGE EXPLOSION

SUMMARY: ANOTHER YEAR OF FORMAL INCOMES POLICY LOOKS
MOST UNLIKELY IN THE LIGHT OF VOTES TAKEN BY THE POWER-
FUL TRANSPORT AND GENERAL WORKERS AND THE MINERS UNIONS.
THIS HAS RAISED THE SPECTER OF ANOTHER PAY EXPLOSION SIMI
LAR TO THE ONE THAT OCCURRED WHEN THE LAST INCOMES POLICY

BROKE DOWN IN 1974-5. THE CURRENT ECONOMIC SITUATION DIFFERS IMPORTANTLY FROM THE ONE WHICH THEN PREVAILED. ON THEIR OWN, THESE DIFFERENCES ARE LIKELY TO PREVENT A REPETITION OF A WAGE EXPLOSION ON THE 1974-5 SCALE. HOWEVER, OTHER FACTORS WHICH ARE NOT NOW VERY CLEARLY PREDICTABLE WILL ULTIMATELY DETERMINE WHETHER WAGES RISE AT UNACCEPTABLE RATES. END SUMMARY.

1. THE RECENT CONFERENCE VOTES BY THE TRANSPORT AND GENERAL WORKERS AND THE MINERS (SEE LONDON 11129) MAKE A FURTHER FORMAL AGREEMENT ON PAY RESTRAINT BETWEEN HMG AND TUC A MOST UNLIKELY PROPOSITION. IN ORDER TO GRASP THE ECONOMIC IMPLICATIONS OF THE PROBABLE DISAPPEARANCE OF INCOMES POLICY, IT IS NECESSARY TO UNDERSTAND THE MAJOR ELEMENTS IN THE PROCESS OF WAGE DETERMINATION IN THE U.K. THESE INCLUDE THE LEVEL OF OVERALL ACTIVITY IN THE ECONOMY WHICH AFFECTS THE LEVEL OF DEMAND IN LABOR MARKETS, THE RATE OF GROWTH IN THE MONETARY AGGREGATES, AND MARKET POWER OF LARGE TRADE UNIONS AND LARGE EMPLOYERS. THE FOLLOWING TABLE COMPARES SEVERAL INDICATORS RELEVANT TO THE STATE OF THE LABOR MARKET DURING THE PERIOD IMMEDIATELY PRIOR TO THE BREAKDOWN OF INCOMES POLICY EARLY IN 1974, THE SUBSEQUENT WAGE EXPLOSION, AND THE LATEST AVAILABLE DATA. ALL FIGURES REPRESENT PERCENT CHANGE EXCEPT FOR THE UNEMPLOYMENT RATE. LATEST
PRE-EXPLOSION WAGE EXPLOSION PERIOD
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	1972IV-1973IV	1974I-1975I	1976I-1977I
GDP	3.2	3.6(1)	1.0
REAL PERSONAL DISPOSABLE INCOME	3.9	4.2(1)	-3.3
RETAIL PRICES	10.2	20.3	16.5
UNEMPLOYMENT RATE	2.2 (DEC.)	3.2 (MAR.)	5.6 (MAR.)
M3 AVERAGE EARNINGS	28.4	10.7	7.2
	12.7	31.7	11.7

(1) INFLATED BY EFFECTS OF 3-DAY WEEK WHICH REDUCED OUTPUT IN 1974I.

2. SEVERAL THINGS ARE IMMEDIATELY APPARENT FROM A COMPARISON OF THESE FIGURES. FIRST, REAL OUTPUT AND INCOMES WERE RISING AT LEVELS WELL ABOVE THE LONG-TERMTREND (2.2 PERCENT) IMMEDIATELY PRIOR TO THE 1974-5 WAGE EX-

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PLOSION. THE LABOR MARKET WAS TIGHT, INFLATION HAD JUST
CROSSED INTO DOUBLE DIGIT RATES, AND WAS ACCELERATING.
THE MONEY SUPPLY WAS EXPANDING, AT AN UNPRECEDENTED RATE,
UNCHECKED BY ANY CONSTRAINTS ON PUBLIC SECTOR BORROWING
OR DOMESTIC CREDIT EXPANSION. REGARDLESS OF THE ACCOM-
PANYING POLITICAL BACKGROUND, IT WAS NEITHER SURPRISING
THAT POWERFUL TRADE UNIONS DEMANDED NOR THAT MANY EMPLOY-
ERS WERE ABLE TO GRANT LARGE WAGE INCREASES DURING THE
PERIOD BEGINNING IN THE SPRING OF 1974.

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3. THE THIRD COLUMN IN THE TABLE DESCRIBES A VERY DIFFERENT KIND OF ECONOMY. THE LEVEL OF ACTIVITY IS WELL BELOW TREND, REAL INCOMES ARE DECLINING SHARPLY, AND THE UNEMPLOYMENT RATE REMAINS AT OR NEAR POST-WAR RECORDS. MONEY SUPPLY GROWTH IS BEING CONSTRAINED BY HMG AS IT FILLS ITS COMMITMENTS MADE TO THE IMF. INFLATION SEEMS SET TO DECLINE PROGRESSIVELY FROM CURRENT LEVELS. UNDER THESE CIRCUMSTANCES, AN UNFETTERED PROCESS OF WAGE DETERMINATION IS LIKELY TO PRODUCE DIFFERENT RESULTS.

4. THE END OF INCOMES POLICY WILL MAKE IT POSSIBLE FOR EMPLOYERS TO MOVE TOWARD RESTORING COMPRESSED PAY DIFFERENTIALS BETWEEN DIFFERENT PAY CATEGORIES. THEY WILL ALSO HAVE TO NEGOTIATE THE INTEGRATION OF PAY INCREASES GRANTED OVER THE PAST TWO YEARS INTO BASIC WAGE RATES USED TO CALCULATE OVERTIME. THESE TWO FACTORS MAY ADD UP TO 8 PERCENT TO CURRENT WAGE LEVELS BUT SHOULD HELP TO RESTORE A MORE NORMAL FUNCTIONING IN THE LABOR MARKET. SUCH ADJUSTMENTS WERE CLEARLY A FACTOR IN THE 1974-5 EXPERIENCE. THEN, HOWEVER, LABOR MARKET PRESSURE COMBINED WITH UNION MARKET POWER ADDED A FURTHER 20 PERCENT OR SO TO WAGE SETTLEMENTS.

5. IN THE COMING PERIOD OF WAGE BARGAINING, LABOR MARKET PRESSURES MAY BE CONSIDERABLY MORE MODEST AS REAL GROWTH IS NOT LIKELY TO BE MUCH ABOVE 1.0 PERCENT. MOREOVER, UNLIKE 1974-5, THE SALARIES OF PUBLIC EMPLOYEES AND CIVIL SERVANTS ARE CURRENTLY SUBJECT TO STRICT BUDGETARY CASH LIMITS INTENDED TO CONSTRAIN PAY INCREASES TO SINGLE DIGITS. AS A RESULT, THE ELEMENT OF WAGE INCREASE ABOVE THE 8 PERCENT OR SO ATTRIBUTABLE TO RESTORING MORE NORMAL LABOR MARKET FUNCTIONING IS LIKELY TO BE SMALLER -- PER-

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HAPS MUCH SMALLER -- THAN THREE YEARS AGO. IN THE ABSENCE OF OTHER CONSIDERATIONS, THE MOST LIKELY RESULT OF A RETURN TO RELATIVELY FREE COLLECTIVE BARGAINING WOULD BE A RISE IN AVERAGE EARNINGS OF 12 TO 18 PERCENT; AT THE LOWER END OF THE RANGE, A FIGURE NOT TOO FAR FROM HMG'S 10 PERCENT TARGET.

6. THUS FAR, THE DISCUSSION HAS CENTERED ON THE UNDERLYING ECONOMIC SETTING. THERE REMAINS THE QUESTION OF THE EFFECT OF GOVERNMENT BUSINESS AND TRADE UNION DECISIONS THAT ARE YET TO BE MADE. IN THE CASE OF THE GOVERNMENT, THESE CAN BE SUMMED UP AS ISSUES OF DEMAND MANAGEMENT: STRENGTH OF HMG'S COMMITMENT TO THE FINANCIAL TARGETS CONTAINED IN ITS LETTER OF INTENT TO THE IMF AND ITS WILLINGNESS TO RESTRAIN PAY SETTLEMENTS IN THE PUBLIC SECTOR.

OTHER FACTORS INCLUDE THE DEGREE TO WHICH THE 12-MONTH GAP BETWEEN PAY SETTLEMENTS UNDER PHASE II AND THE COMING BARGAINING ROUND IS RESPECTED, THE MAGNITUDE OF TRADE UNION DEMANDS, AND THE STRENGTH OF MANAGEMENT RESISTANCE IN THE FACE OF EXCESSIVE WAGE CLAIMS.

7. AS NOTED, HMG IS CONSTRAINED BY ITS COMMITMENT TO THE FINANCIAL TARGETS AGREED IN DECEMBER 1976 WITH THE IMF. WHILE THE SPECTACULAR INCREASE IN BRITAIN'S FOREIGN EXCHANGE RESERVES SINCE JANUARY MAY TEMPT HMG TO ALLOW THESE TARGETS TO BE EXCEEDED IN ORDER TO FINANCE LARGE WAGE INCREASES, THE PM'S COMMENTS IN PARLIAMENT (LONDON 11119) INDICATE THAT HE IS AWARE OF THE POTENTIAL DAMAGE TO INTERNATIONAL CONFIDENCE IF THE COMMITMENTS ARE NOT HONORED. WHAT REMAINS TO BE SEEN IS IF THESE COMMITMENTS WILL BE GIVEN PRIORITY IN THE MONTHS TO COME.

8. IN THE PUBLIC SECTOR, WHERE HMG IS THE EMPLOYER WITH WHICH PUBLIC EMPLOYEES MUST BARGAIN. THE RELATIVELY NEW SYSTEM OF STRICT CASH LIMITS ON DISCRETIONARY PUBLIC EXPENDITURE PROGRAMS PROVIDES HMG WITH A POTENTIALLY POWERFUL LIMITED OFFICIAL USE

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TOOL IN DETERMINING PUBLIC SECTOR WAGES. THE CURRENT BUDGET CONTAINS IMPLIED AVERAGE WAGE INCREASES OF ABOUT 5 PERCENT FOR PUBLIC SECTOR EMPLOYEES DURING THE PERIOD FROM APRIL 1, 1977 TO MARCH 31, 1978. THE FIRST MAJOR GROUP OF PUBLIC EMPLOYEES TO SETTLE AFTER THE JULY 31, 1977 END OF

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PHASE II ARE LOCAL AUTHORITY MANUAL WORKERS WHOSE CURRENT AGREEMENT EXPIRES NEXT OCTOBER. HMG IS LIKELY TO PULL OUT EVERY STOP TO ENSURE THAT THIS GROUP SETTLES FOR A FIGURE CLOSE TO THE 5 PERCENT WAGE INCREASE IMPLIED BY THE CURRENT CASH LIMITS. SHOULD THAT SETTLEMENT BE MUCH IN EXCESS OF 5 PERCENT, HMG'S RESOLVE OVER LATER SETTLEMENTS WILL COME INTO QUESTION. ON THE OTHER HAND, A 5 PERCENT SETTLEMENT WOULD DO MUCH TO SET THE TONE FOR MORE MODERATE SETTLEMENTS AS THE BARGAINING YEAR PROGRES-

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SES. (AFTER APRIL 1, 1978, PUBLIC SECTOR PAY SETTLEMENTS WILL FALL IN A NEW FISCAL YEAR WHOSE CASH LIMITS WILL BE CONTAINED IN THE NEXT PUBLIC EXPENDITURE WHITE PAPER WHEN IT APPEARS EARLY IN 1978.) IT MUST BE RECOGNIZED, HOWEVER, THAT A TOUGH LINE ON PUBLIC SECTOR WAGE SETTLEMENTS INCREASES THE POSSIBILITY OF CONFRONTATION BETWEEN THE GOVERNMENT AND THE TUC, WITH ITS ATTENDANT RISK TO THE LABOR GOVERNMENT'S ABILITY TO SURVIVE (SEPTTEL).

9. THE 12-MONTH GAP BETWEEN PHASE II SETTLEMENTS AND THOSE WHICH COME AFTERWARDS HAS BECOME THE KEY TO WHATEVER MAY REMAIN OF INCOMES POLICY. SHOULD SUCCESSFUL ATTEMPTS BE MADE TO OBTAIN FURTHER PAY INCREASES BEFORE 12 MONTHS HAVE ELAPSED, THE RATE OF INCREASE IN AVERAGE EARNINGS COULD ACCELERATE QUITE RAPIDLY FROM ITS CURRENT ANNUAL RATE OF 10 PERCENT. THIS IS A KEY ELEMENT. PRESUMABLY HMG WILL DEVOTE MUCH EFFORT TO ACHIEVING A FIRM UNION COMMITMENT TO THE 12-MONTH RULE, A BREAKDOWN OF WHICH COULD PRECIPITATE ANOTHER WAGE EXPLOSION. THE

MAGNITUDE OF UNION WAGE CLAIMS AND EMPLOYERS' ABILITY TO HOLD OUT AGAINST THOSE IN EXCESS OF 12-15 PERCENT DEPENDS BOTH ON THE ABILITY OF HMG TO SET AN EXAMPLE IN THE PUBLIC SECTOR AND TO TAKE ACTIONS (E.G., ON PRICES AND TAXATION) WHICH WILL PROVIDE AN INCENTIVE FOR MODERATION.

10. THE EMBASSY IS THE FIRST TO RECOGNIZE THAT THE FOREGOING ANALYSIS DOES NOT LEND ITSELF TO DRAWING FIRM CONCLUSIONS. WHATEVER THE FINAL OUTCOME, THE NEXT PAY ROUND IS UNLIKELY TO COINCIDE WITH ACHIEVING AND SUSTAINING SINGLE DIGIT INFLATION, AND THUS WILL AFFECT CALLAGHAN'S LONG-RANGE POLITICAL STRATEGY (SEPTTEL).

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